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ENHANCEMENT OF ISLAMIC BANKING INDUSTRY: A SRI LANKAN PERSPECTIVE

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ABSTRACT

The modern Islamic banking industry has been growing in Sri Lanka since 1997 as an alternative banking system to the conventional one. Despite the fact that there are a number of hurdles with regard to its sustainability, it is growing significantly. However, it is imperative to take necessary steps to enhance the industry by expanding the application of Islamic banking products and introducing an alternative dispute resolution mechanism for Islamic banking disputes in accordance with the Shariah. Therefore, this paper aims at evaluating as to what extent Islamic banking products are currently in practice and which mechanism is being employed to resolve disputes that arise between Islamic banking institutions and their clients. This paper adopts a qualitative research method and content analysis in order to accomplish the objectives of the study. Primary sources such as the Banking Act No. 30 of 1988 of Sri Lanka, the Banking (amendment) Act No. 2 of 2005 of Sri Lanka, the Sale of Goods Ordinance No. 11 of 1896 of Sri Lanka, the Arbitration Act No. 11 of 1995 of Sri Lanka, the Islamic Financial Services Act 2013 of Malaysia, resolutions made by the Central Bank of Malaysia, decided cases and various secondary sources are used to complete this research. The authors also conducted semi-structured interviews with various stakeholders. Hence, this study finds that there are various issues as well as challenges pertaining to the application of Islamic banking products and the dispute resolution mechanism. Currently, mudarabah, murabahah, musharakah and ijarah are practised by Islamic banking institutions in Sri Lanka. These products are marketed with numerous limitations. The study proposes various instruments based on respective concepts to expand the application of Islamic banking products. Similarly, the litigation has many disadvantages such as delay, costly, loss of privacy and prejudice to the business relationship. In the process of finding a remedy, arbitration is proposed by this study which can be an ideal alternative for the resolution of Islamic banking disputes.

Keywords: *Enhancement of Islamic Banking Industry, Islamic Banking Products, Arbitration in Islamic Banking Disputes, Litigation in Islamic Banking Disputes*

INTRODUCTION

Due to the Islamic revival, which took place in the late nineteenth and at the beginning of the twentieth century, the revolution of the modern Islamic banking industry was born with the establishment of the Mit Ghamr Local Saving Bank, in 1963 in Egypt, which received an overwhelming support from customers. It was the first Islamic banking institution that proved that Islamic principles of transactions were still viable and applicable to the modern banking business (Haron and Azmi, 2009). In line with this, modern Islamic banking reached Sri Lanka in 1997 (Nafees and Ahmed, 2015). Since then, the industry has been witnessing tremendous growth (Cader, 2008). This trend could be noticed when look into Amãna Bank's performance as well as the table1, 2 and 3 which indicate that during a period of 15 years since 1997, more than 18 IBIs have emerged in a small country. In addition, within a short period of emergence in 2011, Amãna Bank, the only fully-fledged Islamic bank, has managed to attract more than 100,000 customers (Amãna Bank, 2015). Similarly, the deposit ratio has also increased dramatically from 54% in 2012 to 83% in 2013 (Tan, 2015).

Table 1: 2014 Financial Performance of Amãna Bank

	Amount (in LKR)	**Year-on- year -growth (%)**
Pre-tax profit(Q4)	88.5 million	-
Net loss	80.3 million from 438 million	-
Total assets	34.9 billion	49
Net financing income	1.21 billion	68
Total operating income	1.67billion	57

Source: Tan, V. (2015), "Sri Lanka: Good Things to Come", *Islamic Finance News*, 11 March, Vol. 12 No. 10, available at: http://www.islamicfinancenews.com/ifn-country-analysis-srilanka (accessed 11 July 2015).

Sri Lanka seems to be more pro-active as it has amended its Banking Act No. 30 of 1988 in 2005 to enable Islamic banking to be operated in the country (see section 86 of the Banking Act No. 30 of 1988 of Sri Lanka). However, in order to sustain the industry, there is an immense need to expand the application of Islamic banking products as well as the introduction of a dispute resolution mechanism which complies with the principles of Shariah. It is observed that application of products is very limited and disputes among stakeholders are adjudicated in civil courts where common law is applicable.

1.1 Method and Materials

The study has adopted a qualitative method of research. Primary and secondary sources are consulted to reach objective of the study. Books, journal articles, annual reports and statutes

were referred. Personal interviews from stakeholders were also conducted to strengthen the study. Interviewees were, among others, the president of All Ceylon Jamiyyathul Ulama ACJU (Council of Muslim Theologian), managing directors of all Islamic banking institutions, academicians and chief executive officer of ICLP Arbitration Centre. These personalities are knowledgeable on banking as well as on Islamic banking. As the study focused on legal point of view, it preferred to adopt a qualitative method which is more conducive. There is no proper study on Islamic banking so far or it is rare in Sri Lanka and consequently, the literature on this area is also very rare.

1.2 Emergence and Development of Islamic Banking in Sri Lanka

Scholars have different views on how and when the idea of Islamic banking has emerged in Sri Lanka. Primarily, the Islamic Service Society was started in the 1980s by a group of people under the guidance of Al-Shaykh Khaliq at Akurana in the Kandy district of Sri Lanka. This effort was not appreciated by people in a manner whereby they thought of dealing with Islamic banking system. In fact, the real effort to introduce Islamic banking into Sri Lanka was made by another group of people comprising bankers such as Ismail Deen Marikar and Uthman Qasim, and some of other qualified people in the banking sector during the period of 1994-1995. Meanwhile, al-Shaykh Taqi Usmani, a prominent Islamic finance scholar in Pakistan, paid a visit to Sri Lanka on the request of above mentioned people with the objective of advising Sri Lankan Muslims on any possibility of establishing an Islamic banking system in the country. At the same time, the local *ulama* (Muslim scholars) had involved in serious discussion with regard to the same subject. After due consideration, in 1997, Amãna Investment Ltd (AIL) was established as an investment company. This is considered a milestone in the history of Sri Lankan Muslims (Nafees, S. M. M. interviewed Mufti Al -Shaykh Rizvi on 18 August 2009 in Colombo, Sri Lanka). This enabled Muslim customers of conventional banks transfer their accounts and investments to the newly established Islamic banking institution. AIL commenced its operation in line with the Shariah principles of transaction at the time the people did not have any knowledge of Islamic banking and even the terminology related to Islamic transactions such as *mudarabah, musharakah* or *ijarah* was not much familiar to the people. Thus, Islamic banking came to exist and was a long awaited dream of the Sri Lankan Muslims. The arrival of the Islamic banking system rendered them an opportunity to meet their banking needs in accordance with the Shariah (Riyazi, 2007). Hence, the year 1997 should be considered as the year of emergence of Islamic banking in Sri Lanka (Nafees and Ahmed, 2015).

The Islamic banking business in the country is carried out either by way of fully-fledged Islamic banking system or Islamic windows. At present, there are one fully- fledged Islamic bank and eight Islamic windows in the country. Besides, there are more than nine institutions that carry out Islamic banking business are not regulated by the Central Bank of the country. They are either investment companies or associations. Although they are not registered as banks, they

are still recognised as Islamic banking institutions among public. These may be categorised as potential Islamic banks (Nafees, S. M. M. interviewed Habeebullah on 25 January 2015 in Colombo, Sri Lanka).

Table 2: Fully-fledged Islamic Banking in Sri Lanka

Fully-fledged Islamic Bank	**Potential Islamic Banks**
Amãna Bank Ltd	Amãna Service Hand
	Islamic Service Society Akurana
	Islamic Service Association Thihariya
	Cresent Islamic Investment Company
	AlIF Islamic Finance
	Kinniya Service Society/Hidma Investment
	Thihariya Service Association
	Adl-Capital Ltd
	Al-Noor Foundation,

Table 3: Islamic Windows in Sri Lanka

Islamic Windows	**Potential Islamic Windows**
Muslim Commercial Bank (MCB)	American Express Bank Ltd
Al-Wafa Islamic Financial Service jointly owned by the Bank of Ceylon Ltd & Merchant Bank of Sri Lanka (Tan, 2015)	Seylan Bank
Peoples' Bank Ltd	Sanasa Bank
LOLC Islamic Finance Unit	Sampath Bank
Commercial Bank of Sri Lanka	HSBC Sri Lanka
Hatton National Bank	DFCC Vardhana Bank
Richard Peris Finance's Shariah (Tan, 2015)	Union Bank of Colombo and
NDB Shareek (Shariah unit of National Development Bank) (Tan, 2015)	The rest of the conventional banks

1.3 Regulation of Islamic Banking

The Islamic banking industry is regulated by the Shariah and positive laws. The Shariah is based on primary sources of Islam that will be implemented by way of Shariah boards whereas positive law is promulgated by the Central Bank of Sri Lanka to safeguard public interest. In this sense, Banking Act No.30 of 1988 and the Banking (amendment) Act No. 2 of 2005 play an important role in regulating the Islamic banking industry.

The ACJU plays a significant role in mitigating the shortcoming of the legislation on Shariah governance (Mubarak, 2009). It is a non-governmental organisation that was established in 1924 has been incorporated under the Act No. 51 of 2000 of Parliament of Sri Lank. It is not a statutory body whose ruling is not considered legally binding. It has several divisions for different issues including a division for Islamic banking and finance. This service is voluntarily rendered by the ACJU in the interest of Muslim community in Sri Lanka. Although it is not mandatory for IBIs to comply with its ruling, they follow it in general for the purpose of convincing customers (All Ceylon Jammiyyathul Ulama, 2015). Meanwhile, it is to be noted that Amãna Bank is a member of AAOIFI and it complies with its ruling in terms of Shariah compliance. However, it is suggested for IBIs to adopt voluntarily its ruling in order to constitute a consistency in the application of Shariah principles governing Islamic banking. Nevertheless, Shariah governance must be legislated in due course for the sustainability of the industry. In some countries, the role of the Shariah has been recognised significantly. Malaysia is a good example and it has done a commendable job with regard to the regulation of the Islamic banking industry pertaining to the role of the Shariah. Accordingly, all Islamic banking institutions are bound to appoint Shariah advisory boards that would consult the Shariah Advisory Council (SAC) in the case of conflict of opinion. The SAC has been set up under the Central Bank of Malaysia. The courts and arbitral tribunals are instructed to consult the SAC whose opinion is binding on them (see sections 27-38 of the Islamic Financial Services Act 2013 of Malaysia). Hence, this sort of legislation is imperative for the sustainability of Islamic banking industry in Sri Lanka.

1.4 Law of Contract and Islamic Banking

Sri Lanka is a common law jurisdiction where English law is applied to all matters except a few issues which are governed by Roman-Dutch laws and personal laws such as Kandian and Muslim personal laws by which contracts, marriage, divorce and matrimonial related issues are adjudicated. In addition, ample areas of contract law are governed by Roman-Dutch law although statutes law has been subject to many reforms. However, such laws have been modified in part by judicial decisions. Contracts for the sale of land are generally governed by Roman-Dutch law. Accordingly, section 2 of the Prevention of Frauds Ordinance 1840 provides the essential formalities to be observed. Thus, a contract pertaining to a conveyance *inter vivos* of immovable property must be executed before a notary and two witnesses. The law governing capacity to contract is the Roman-Dutch law or the special law applicable to the parties where such law exists. If the special laws are silent, the Roman-Dutch law applies. The Roman-Dutch law in relation to the capacity of minors to enter into contracts is applicable in Sri Lanka (Cooray, 2003).

Apart from those matters, the Sale of Goods Ordinance governs and provides the necessary legal matters related to contract other than matters governed by Roman-Dutch law. It contains 59

provisions which have been divided into six parts. The first part discusses the formation of the contract while the second part talks about the effects of the contract. Performance of the contract is described in part three. Part four elaborates the rights of the unpaid seller against the goods whereas actions for breach of the contract are provided in part five. The last part consists of supplementary provisions including interpretation (see the Sale of Goods Ordinance, No. 11 of 1896 of Sri Lanka).

Having examined these provisions, it is observed that there is not much of an obstacle in implementing contracts related to Islamic banking. Rather, it seems that it is more conducive and supportive to Islamic banking products. For example, in regard to the subject matter of the contract, the section 6(1) the Sale of Goods Ordinance, No. 11 of 1896 provides that "The goods which form the subject of a contract of sale may be either existing goods, owned or possessed by the seller or goods to be manufactured or required by the seller after the making of the contract of sale, in this ordinance called "future goods". According to this provision, any kind of contract of sale including *bay- al-Istisna* could be practised simply. Similarly, section 14 elaborates the sale by description that is similar to *bay-al-wasf*. It provides that: "Where there is a contract for the sale of goods by description, there is an implied condition that the goods shall correspond with the description".

Therefore, all contracts pertaining to Islamic banking are governed by the English common law and Roman Dutch laws. Once a contract is entered into in accordance with the existing laws, there would not be a problem. Nevertheless, when there is a dispute, most of the time, the dispute resolution system that lies in currently civil courts would not reflect the real purpose of the Shariah. For example, in the case of *Islamic Investment Company of the Gulf (Bahamas) Ltd. (IICG) v. Symphony Gems NV & Others (Symphony)* [2002] WL 346969, QB Comm. ct 13 (the first case on Islamic banking heard in the English Court), the plaintiff (IICG) concluded a *murabahah* financing agreement with the defendant (Symphony). In accordance with the agreement, IICG had to provide purchase and sale arrangements to enable Symphony to buy precious stones and gems. Accordingly, the deal was made for US$ 15 million which was sold back to Symphony at the price of US$ 15,834,900 and that price had to be settled on installment basis. Due to non-payment of any installment as agreed, the matter was brought to the High Court in the United Kingdom as agreed by the parties. It has to be pointed out that the High Court called for expert evidence to understand and ascertain whether the agreement was based on the *murabahah* concept. According to the expert evidence, the agreement did not consist of the essential characteristics of *murabahah* contract and consequently it was invalid according to the Shariah. However, the court applying the English law concluded that there was a valid contract.

When commenting on the above decision, Engku Rabiah Adawiah argues as follows and the author totally agrees with the view.

> "*This case clearly illustrates the anomalous situation that an Islamic financial transaction may be in due to the 'less than proper' implementation of Islamic legal principles in the purported Islamic transaction. This anomaly is further exacerbated by the choice of the parties to be adjudicated by a non-Islamic court in a non-Islamic jurisdiction who may not give due recognition and enforcement to the Islamic legal principles in arriving at the judgment. As a result, a transaction that is non-compliant with the Shariah may still be validated and enforced by the court of law. This will translate into the bank being able to recover the amount claimed, it's selling price inclusive of profits, despite the transaction being non-compliant with the Shariah. If this is the result of the judgment order, the noble aim of having Islamic banking and financial services that comply with the Shariah will be defeated"* (Adawiah, 2008).

Therefore, alternative mechanism is sought here in order for Islamic banking contracts to be Shariah compliant.

RESULT AND DISCUSSION

2.1 Islamic Banking Products

With regard to Islamic banking products, although there are some legal impediments, they are still sold successfully. However, it is observed that their application is very minimal. Thus, there is an immense need to expand them to a greater extent in order for people to access all kinds of Islamic banking products that are already available globally. In this sense, the expansion is essential so as to sustain the Islamic banking industry in the country as well to compete with conventional banks.

Only a few Islamic banking products are currently being marketed by Islamic banking institutions (IBIs) in Sri Lanka. For example, the *mudarabah* is being used only for deposit purposes and is rarely used to mobilise the fund by sharing with customers through financing for valuable projects. In case of *murabahah*, for example, it is mostly used for buying a commodity and selling it on installment basis. However, there are a number of avenues to expand their application. In this sense, the application of *mudarabah, musharakah, murabahah* and *ijarah* banking products can be extended as discussed below.

2.1.1 Mudarabah

The practice of *mudarabah*, apart from its normal application, it can be extended as suggested below.

(a) Mudarabah Management Investment Certificates

This is administrated by a fund management scheme. A trustee may be appointed to safeguard the interests of the certificate holders. These certificates cannot be encashed prematurely and the income may be paid periodically (Hussain, 1997).

(b) Mudarabah Investment Funds

A group of investors will be pooled by a *mudarib* through a trust or special purpose vehicle (SPV). A certain percentage of the share capital may be funded by the company and the remaining percentage will be raised through the issuance of *mudarabah* certificates which can be traded on the stock exchange (Hussain, 1997).

(c) Mudarabah Floating Negotiable Instrument of Deposit (FNID)

This instrument is devised as follows:

- A customer deposits his money into an Islamic bank;
- The bank accepts the deposit and issues FNID;
- FNID is tradable in the secondary market;
- Upon maturity, the holder of FNID receives the principal sum of FNID plus declared dividend by returning it to the bank (see Resolution No. 9 of the Central Bank of Malaysia, BNM/RH/012-2, pp. 3-4).

(d) Mudarabah Human Capital Certificates

Issuance of human capital certificates based on *mudarabah,* which will help mobilise *mudarabah's* other half. It is obvious that *mudarabah* is one of the most important modes of financing for an economic project. Thus, two different parties are involved in *mudarabah* contract. One is money capital and other human capital. Islamic banks are engaged in the mobilisation of banking resources. This is the conventional function of the banks and it will remain so. However, IBIs need to do more beyond this point by mobilising human resources to bring about a proper match between two types of capital embodied in the contract. For this purpose, IBIs may float human capital certificates. They must identify the area of human skill that needs to be matched with financial resources in a given set of projects. These certificates could be sold in an open market on two conditions: one is the purchaser of the certificate must undertake the work of the project on a co-operative basis; the other he/she will receive the required financial resources to implement the project. The certificate holders will obtain a part of the salary in terms of money and the balance in terms of share of project involved. An IBI can enter into a *mudarabah* contract. As such, these human capital certificates enable the industry to achieve two objectives, first, providing a guarantee of livelihood and giving incentives to workers to take part in profit-sharing. This is in fact better than the present fixed wage system, which leads investors alone to bear the risk of changes in output and profits. Conversely, human capital certificate system provides for distribution of risk which enhances the productive efficiency of the firm (Mannan, 1990).

2.1.2 Musharakah

Apart from ordinary application of *musharakah,* it can be extended as follow.

(a) Musharakah Certificates

A viable project that can be offered to the public seeking financing from an Islamic bank which arranges the sale of *musharakah* certificates of the said company to the investors and general public is prepared. A trustee can be appointed to monitor the interest of the certificate holders. The proceeds of the sale of the *musharakah* certificates will be passed on by the bank to the investing company that periodically issues profit warrants for disbursement to certificate holders through an Islamic bank. The certificate holders must be able to sell these certificates in the money market in order to fulfil their temporary financing needs. In addition, upon the maturity of the *musharakah* projects, the certificates will become redeemable by the company as agreed in advance (Hussain, 1997).

(b) Shared Certificate of Investment

Under this set up, a general pool is formed and upon maturity, the certificates will be redeemable. The certificate holders will be considered to own the net assets of the company that issues such certificates. Profits must be shared in a ratio as set out in the certificates. Losses are shared in accordance with the amount of contribution (Hussain, 1997).

(c) Musharakah for Multi Purposes

The concept of *musharakah* may be used for income-yielding public utility projects or project financing such as the establishment of a power plant and infrastructure projects such as construction of highways. Revenues could be generated through tariffs or tolls (Ariff and Mannan, 1990).

2.1.3 Murabahah

Besides the normal application of *murabahah,* it may be expanded as outlined below.

(a) Commodity Murabahah Programme

This product enables IBIs to solve liquidity problems. A bank which has excess liquidity, can manage its liquidity to purchase commodities from a broker on cash basis. The Central Bank may sell the commodities to another broker on spot price at the original price. An agent to sell the commodities in the commodity market can be appointed. Upon maturity, the bank will be able to receive the amount equivalent to the principal plus profit. Similarly, in case an Islamic bank faces a liquidity problem, the Central Bank may buy the commodities from a broker for cash which may appoint a bank that encounters *ad hoc* liquidity problem as its agent to buy the commodities from the commodity market. The bank will obtain funds for outright purchase of

commodities, which sells them to another broker at the original cost price to net off the commodity position that it keeps once it buys from the Central Bank. Upon maturity, the bank pays the Central Bank for the funds equivalent to the principal plus profit (Dusuki, 2007). Although this transaction is not approved by the OIC Fiqh Academy or similar organizations in the world, it has been approved by Shariah Advisory Council (SAC) of Central Bank of Malaysia where this instrument is practised widely (see Resolution No. 42 of the Central Bank of Malaysia, BNM/RH/012-2, p. 13).

(b) Murabahah through Shares

IBIs may purchase shares and sell them based on *murabahah.* The clients must not be appointed as agents for purchasing purpose but the dealing must be done through brokers. The risk that likely occurs during the period of transfer must be borne by the bank (see Resolution No. 22 of the Central Bank of Malaysia, BNM/RH//GL 012-2, p. 7).

2.1.4 Ijarah

IBIs, apart from their normal practice of *ijarah,* may consider it to extend as proposed below.

(a) Securitisation

The securitisation promotes a secondary market. Due to the ownership of *ijarah* asset remaining with the lessor, he may sell it in whole or in part to a third party who may become the new owner. This asset may be sold to one party or a number of parties (Usmani, 2008).

(b) Ijarah Mode of Financing

Ijarah may be used as a mode of financing to enable customers to consume durable goods and equipment such as ships, aircraft and heavy machineries without having purchasing them. The customer pays a specified amount in cash as rental of the leased asset over a period of time as agreed by the parties (Hussain, 1997).

(c) Islamic Hire Purchase

This resembles the conventional hire purchase and it is free from elements which are not approved by the Shariah. This product has been devised based on various principles such as *al-ijarahmuntahiyah bi al-tamlik, al- ijarahwa al-iqtina, al-ijarahthumma al-bay* etc (El-Din and Abdullah, 2007).

(d) Forward Lease

This is known as *al-ijarah al-muwafalah fi al-dhimmah* in *fiqh.* Rental is paid in advance and leased product is received later. This is an exception to a normal *al-bay* (sale). In addition, for any instrument which seems similar to the conventional, its counterpart must be replaced by a better alternative. For example, *Bay Bi-thaman Ajil* (BBA) is subject to various criticisms from scholars as well as customers. Studies suggest that most of the customers do not like to utilise it

to secure a home. Further, they consider that the present practice of BBA does not bring about justice, equality and social well-being. Hence, it must be re-shaped to comply with the Shariah. Alternatively, *musharakah mutanaqisah* (diminishing *musharakah*), which is an emerging new concept without any shortcomings in relation to the Shariah compliance, must be promoted. It has to be pointed out that this concept is fast gaining acceptance (Meera and Razak, 2009).

2.2 Other Factors to be considered by Islamic Banking Institutions

Although these are not legal requirements, in order to safeguard the Islamic banking industry from abuse or misappropriation, the following measures are stressed for its sustainability in the long term.

2.2.1 Size of Islamic Banking Institutions

As far as the size of the Islamic banks is concerned, it is a vital issue to consider. Islamic banks born like boutiques are not good for a stable industry. Munawwar Iqbal rightly points out that "It is an important variable in determining the scale and scope of efficiencies. In the wake of technological change and globalisation, Islamic banks must prepare themselves to handle much larger operations and to deal with internationally minded and financially sophisticated customers. The required infrastructure as well as the larger and geographically wider scope of operations calls for a larger bank in size. There is a worldwide trend of mergers. On the other hand, in the last few years several banks and financial companies, which were already large in size, have merged to form mega-banks. As against this, the available data shows that Islamic banks and financial institutions are much below the optimum size. More than 60% of Islamic banks are below the minimum size of a bank recommended by theoretical studies (US$500 million in assets). The assets of the largest Islamic banks are equal to only 2% of the assets of the largest bank in the world (Iqbal, 2003). Hence, the same situation is prevalent in Sri Lanka too where an amalgamation among small Islamic banking institutions may therefore be considered to become successful big Islamic banks.

2.2.2 To Make an Awareness of Islamic Banking

Despite the substantial growth of Islamic investment funds in recent years, there have not been many such funds in Sri Lanka due to the fact that the investors do not have sufficient confidence in these institutions as they are not like conventional financial institutions. As Sri Lankan Muslims are a business community, they can emerge as potential investors if they are educated properly about Islamic banking. Muzzam Ali rightly says that "As long as the rich Muslims do not place their funds in Islamic banks; Islamic banking will not be able to meet the expectations that were raised at the time of its launching" (Ali, 2005). For investors who want to avoid *riba* in their financial dealings, there were not very many options in Sri Lanka prior to the emergence of Islamic banking. For a long time the only available options were either to deposit in a current account in the conventional bank or invest in equity. There was a prevalent view that investing in equity is always halal. People only recently have begun to understand that the equity must also

be Shariah compliant. Hence, Islamic banking system is a boon for those who require banking services accepted by the Shariah.

2.3 Precautions Taken to Mitigate Risk Related Issues

It is also most important for IBIs to address risk related issues in order to win the hearts of customers.

2.3.1 Adoption of Basel Concept

The IBIs may voluntarily come forward to adopt the system the conventional banks use in order to cultivate trust and confidence in the hearts of customers. The latest Basel concept with necessary modifications conducive to the Shariah might be adopted by the IBIs. The objective in adopting Basel is that banks are prudent in maintaining sufficient reserves to protect themselves and their depositors against any unexpected events in their loans, their operations or the market itself. The mechanism adopted here is that a bank is instructed to set aside capital, which belongs to the bank, for each of a set of defined categories of risk. This is like a cushion provided against things, which may possibly go wrong unexpectedly. More capital ensures less risk.

2.3.2 The Financial Ombudsman

This is a voluntary scheme established by the banking industry, registered finance companies, primary dealers and leasing companies supervised by the Central Bank of Sri Lanka. This body was incorporated in 2003 and is called Ombudsman Sri Lanka (Guarantee) Ltd. The objective of the establishment of this scheme is the satisfactory settlement of disputes and complaints. This scheme resembles the Financial Mediation Bureau of Malaysia. Hence, Islamic banking institutions may join this scheme (The Financial Ombudsman Sri Lanka, 2003).

2.3.3 Takaful of Deposit

Another way to convince people is with the introduction of *takaful*. All institutions dealing with Islamic banking business may insure their deposits in *takaful* companies locally or in offshore *takaful* companies like in Malaysia where the political stability and a strong financial system are in place. Similarly, for example, in 1993, a deposit protection scheme was introduced under which deposits with the Bahrain offices of all commercial banks are protected in the event of a bank failure. This scheme provides up to the lesser of three quarters of the total amount or US$40,000. Government banks including the Central Bank of Bahrain and related parties are not entitled to this protection. Payments under the scheme will be met by contributions from all other commercial banks (Islam, 2003).

2.3.4 Keep an Eye on Islamic Banking Institutions that Newly Emerge

When a new institution is commenced to involve in Islamic banking business, the existing IBIs should also ensure that it complies with the Shariah and other regulatory standards. This is because when any institution faces bankruptcy or is liquidated due to the failure of the system, it

will prejudice the existing IBIs and it may lead into a perception that it is the failure of Islamic banking system itself. Full co-operation among IBIs would also convince and encourage the masses to deal with them extensively. Cylinco Islamic Profit Sharing and Al-Barakah Islamic Financing (ABC) are good examples for failed Islamic banking institution in Sri Lanka. Although Central Bank is functioning as a monitory body, it is the duty of Islamic banking industry players to advise it, voluntarily for the best interest of innocent customers on any malpractice of Islamic banking system due to the fact that the failure of Islamic banking may be construed as the failure of Islam.

2.3.5 Legal Supervision

There are issues related to ownership. The ownership is in the hands of banks until the transaction is completed. During this period, actions of customers may assign liability to the banks. Fault based liability, environmental liability; occupier's liability and product liability are among them. All contracts, therefore, should be entered under a proper legal supervision. This precaution must be taken when *ijarah* products are sold. It is mandatory and a well-known fact in the Shariah for an IBI to own a commodity before it enters into a lease contract. While ownership lies with the bank, it may be liable under the law of Sri Lanka for any offences committed by a lessee. Therefore, more precaution must be sought by IBIs in this respect.

2.3.6 Shariah Governance

It is advisable to set up a separate unit in the Central Bank for Islamic financial institutions to oversee the operation of IBIs and other Islamic financial institutions. It is unfair to let the institutions to decide their competitiveness with regard to Shariah compliance. Additionally, the author totally agrees with Ziya Aldeen Ahmad who can be quoted in support of the author's argument: "The guidance for all institutional developments in an Islamic society is to be derived from the principles of the Shariah. The form and content of Islamic banking practices have therefore to be deduced from the teachings of Islam. There was no proto type of modern banks in the early history of Islam. Even in the Western countries, banking in the form in which it exists today is of comparatively recent origin. The attitude of Islam to all known innovations is that nothing should stand in the way of their adoption if they are useful for human society and do not conflict with the fundamental principles as enunciated in the Holy Qur'an and the *Sunnah* (Zaman, 1995).

2.3.7 The Role of Academicians

There are a number of institutions that provide Shariah based education in Sri Lanka where considerable Muslim scholars are engaged in the teaching profession. However, the motive to engage in constructive researches seriously seems to be lacking. They must be encouraged to conduct researches in the area of Islamic banking, especially in Shariah governance in order to help the industry in Sri Lanka. In this sense, there is a public university, South Eastern University of Sri Lanka, where there is an exclusive department for Islamic finance education,

which may seriously undertake meaningful researches on Shariah compliance of Islamic banking (Nafees, 2011).

2.4 Adoption of Arbitration as a Dispute Resolution Mechanism for Islamic Banking Disputes

Resolving disputes in relation to Islamic banking in a timely, fair, and cost effective manner is a fundamental part of Islamic banking, which helps successfully develop the industry. In addition, as soon as an Islamic bank becomes involved in large, multifaceted disputes the attention and time of the management are diverted from its prime objective. To seek courts for resolving these disputes is time consuming, expensive, and subject to delays and other impediments that may discourage the smooth running of the industry. Furthermore, court cases damage the customer-bank relationship and the good reputation of the bank. Consequently, a better dispute resolution mechanism, alternative dispute resolution (ADR) is being recognised and practised widely in every part of the world. One of the more important branches of the ADR is arbitration, which is preferred by disputing parties to litigation and which has proved to be a real viable alternative to litigation. In line with this, Sri Lanka has also developed a marvellous and comprehensive piece of legislation in relation to arbitration, which offers a flexible, economical, confidential, speedy and impartial process for the treatment of all types of commercial disputes. However, this method has not been adopted by IBIs in Sri Lanka yet (Adawiah, 2008; Ali *et al*., 2007; Menkel-Meadow, 2004).

The Arbitration law in Sri Lanka is comprehensive and conducive to help solving Islamic banking disputes. More importantly, the Act provides all the supports needed to resolve the disputes outside the courts. The parties in dispute are free to choose the seat of arbitration, the law and the manner of the proceedings. This enables the banks to opt for the Shariah as a choice of law as Islamic banking is based on the principles of the Shariah. This is really an encouraging factor for the industry players. As the Sri Lankan authorities know that litigation is more expensive and ineffective to resolve commercial disputes, it has developed such a comprehensive arbitration law in Sri Lanka. It has to be pointed out that the Arbitration Act No. 11 of 1995 of Sri Lanka encourages the parties to resolve the disputes by way of mediation or reconciliation even during arbitral proceedings. The sole objective of the Act is to inspire the disputing parties to resolve their disputes as early as possible outside the courts. The court system may be ineffective in resolving commercial disputes due to a tight budget, lack of trained judges and a number of rigid formalities associated with it (Amerasinghe, 2007).

In addition, foreign arbitral awards are also recognised and enforceable in Sri Lanka without any reservation, which enables the Islamic banks to be involved in business globally as there is an effective dispute resolution mechanism. Sri Lanka has given effect to its obligation under the New York Convention and the courts of Sri Lanka are conscious of the responsibility and commitment attached to Sri Lanka's international obligations and they are committed to honouring foreign arbitral awards without resorting to technicalities (Iswaran, 2007).

Most importantly, the award is treated as a judgment held in the court of law. If any party refuses to enforce the award, there are provisions for the High Court to take necessary steps to enforce it. This situation makes the parties to the arbitration agreement more confident in the system (El-Din and Abdullah, 2007; Ali *et al*., 2007). Another notable observation is that the Act allows foreigners to be appointed as arbitrators of proceedings held in Sri Lanka. This is a really commendable arrangement, which enables Islamic banks to bring Islamic banking experts from overseas (Nafees, S. M. M. interviewed Hermamali Amarasinghe, the CEO of the ICLP Arbitration Centre, on 18 August 2015 in Colombo, Sri Lanka; see also Marsoof, 2007). Hence, based on the above elaboration, it is clear that the adoption of arbitration as a dispute resolution mechanism will enable IBIs to incorporate the Islamic law as a governing law which is conducive for Islamic banking disputes (Hassan and Win, @ Ahmed, 2012).

CONCLUSION

Although there are a numbers of issues, challenges and obstacles for Islamic banking industry in Sri Lanka, its progress is ambitious and encouraging. Product expansion and dispute resolution mechanism play a major role to sustain the Islamic banking industry in Sri Lanka. As such, as suggested above, *mudarabah*, *musharahah*, *murabahah* and *ijarah* banking products could be expanded and they are already available in abundant in other countries. Although some products have high risk, they are still marketed successfully as people are aware of the nature of Islamic finance. Further, arbitration may be introduced for dispute resolution in the country. Civil courts are not competent to adjudicate Islamic banking disputes as they are based on Shariah and even civil courts are in favour of arbitration thereby commercial disputes are resolved outside the courts.

In addition, all agencies related to the Islamic banking industry in the country are highly expected to play their respective role effectively, timely and constructively. In this sense, the government of Sri Lanka, regulators, Islamic banking institutions, practitioners, Islamic and Muslim Scholars (Ulama) have to work together to take the industry from the limited application to broader implementation. It is the duty of the stakeholders of this industry to shape it so as to lead to a sustainable economic development in the country where an opportunity to consume Islamic banking services be given indiscriminately. Islamic banking services are not reserved for Muslims only, but there is potential for them to be used by all the people irrespective of religion, language or ethnicity based on ethical basis, which strives to establish justice, fairness, benevolence and good values. Eventually, as Islamic banking is new to Sri Lanka, constant research is imperative for sustainability of the industry. In this sense, further empirical researches may help find solutions to various issues faced by Islamic banking industry in the country.

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